Financial Sector Origins of Economic Growth Delusion

by Frederic Malherbe and Michael McMahon

Discussion, January 17, 2017

Antonio Fatás

Nice and ambitious paper

- A challenge to traditional view of business cycles
- Provides insights on recent productivity and growth trends and the role of financial sector
- Challenges hysteresis hypothesis as well as Gordon/Fernald view of slowdown in innovation (although it can also be seen as a complement)

The role of pre-crisis period

- Business cycles typically modelled as frequent and small symmetric shocks. No role for pre-crisis dynamics

- This paper is about the pre-crisis dynamics and the role of financial/investment excesses that result in suboptimally higher GDP and fool economic forecasters

- The paper does not explain crisis dynamics per se. It is about comparing GDP levels when regulations change.

Conclusion

- We need more papers like this one that challenge the traditional view of business cycles
- I find the overall story plausible and consistent with anecdotal evidence
- But remain more skeptical about how much it explains of the fall in GDP relative to previous trends (but I am biased)

Theory

- Distortion in allocation of an endownment to capital/consumption due to presence of deposit insurance.

- Capital, GDP too high – consumption too low.

- Effects stronger if banks are allowed to leverage their bets.

Theory

- Overall story is plausible and consistent with anecdotal evidence.
- Details matter and some might not be realistic (although it might not matter much):
  - Banks do not care about low state (always default – zero cost)
  - World absorbs all risk. Welfare is about expected ‘wealth’
  - Closed economy in terms of resources
  - What happens when the crisis is over?
  - Does a financial distortion always lead to higher GDP? Misallocation might not be reflected in level of GDP
  - Policy: why not risk-based deposit insurance premium?

Empirics

- Here is where the paper becomes really ambitious
- Challenge: find specific details of the model that can be matched into data
- The paper is about levels, not growth.
- Assumption: growth dynamics are well captured by intuition about levels

Empirics

- Idea #1: look at behavior of NDP to capture welfare before the crisis.

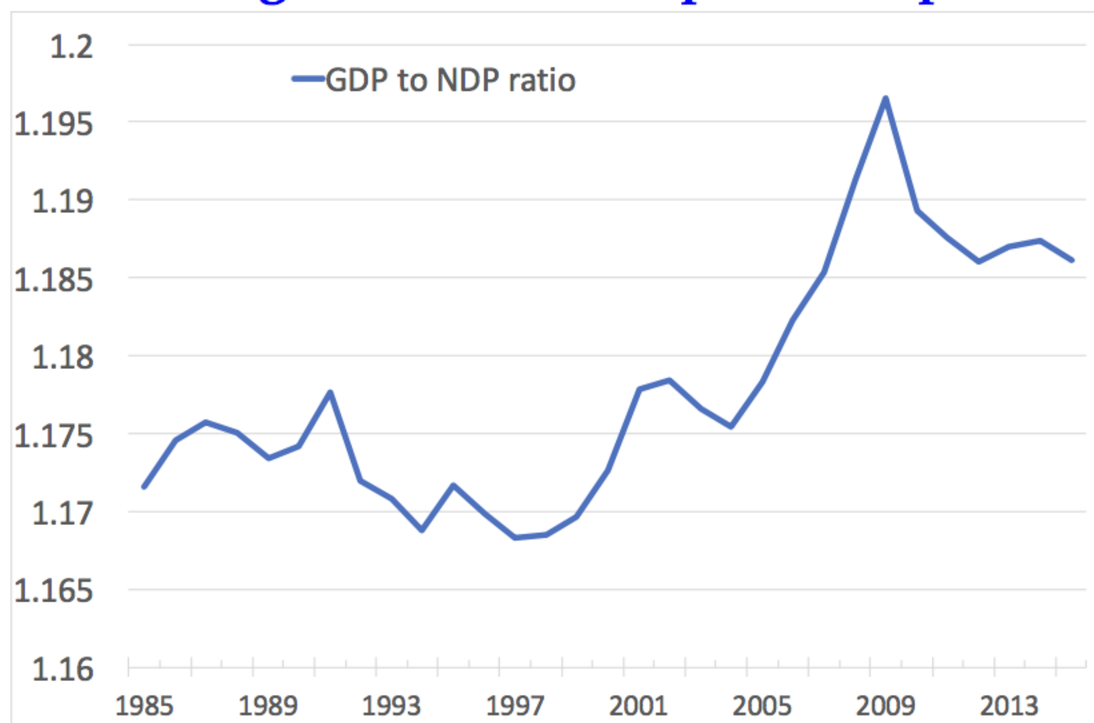
- NDP = Welfare is standard in many models. Consumption right measure of welfare, not GDP (Jones and Klenow). (double counting)

- Model predicts excessive capital which means lower NDP relative to GDP. NDP= GDP – depreciation but also = GDP-Capital = GDP-Investment = Consumption

- But any model where investment / capital stock grows faster than GDP produces a similar prediction. There is nothing inefficient about an increasing investment to GDP ratio unless we can compare to long-run consumption.

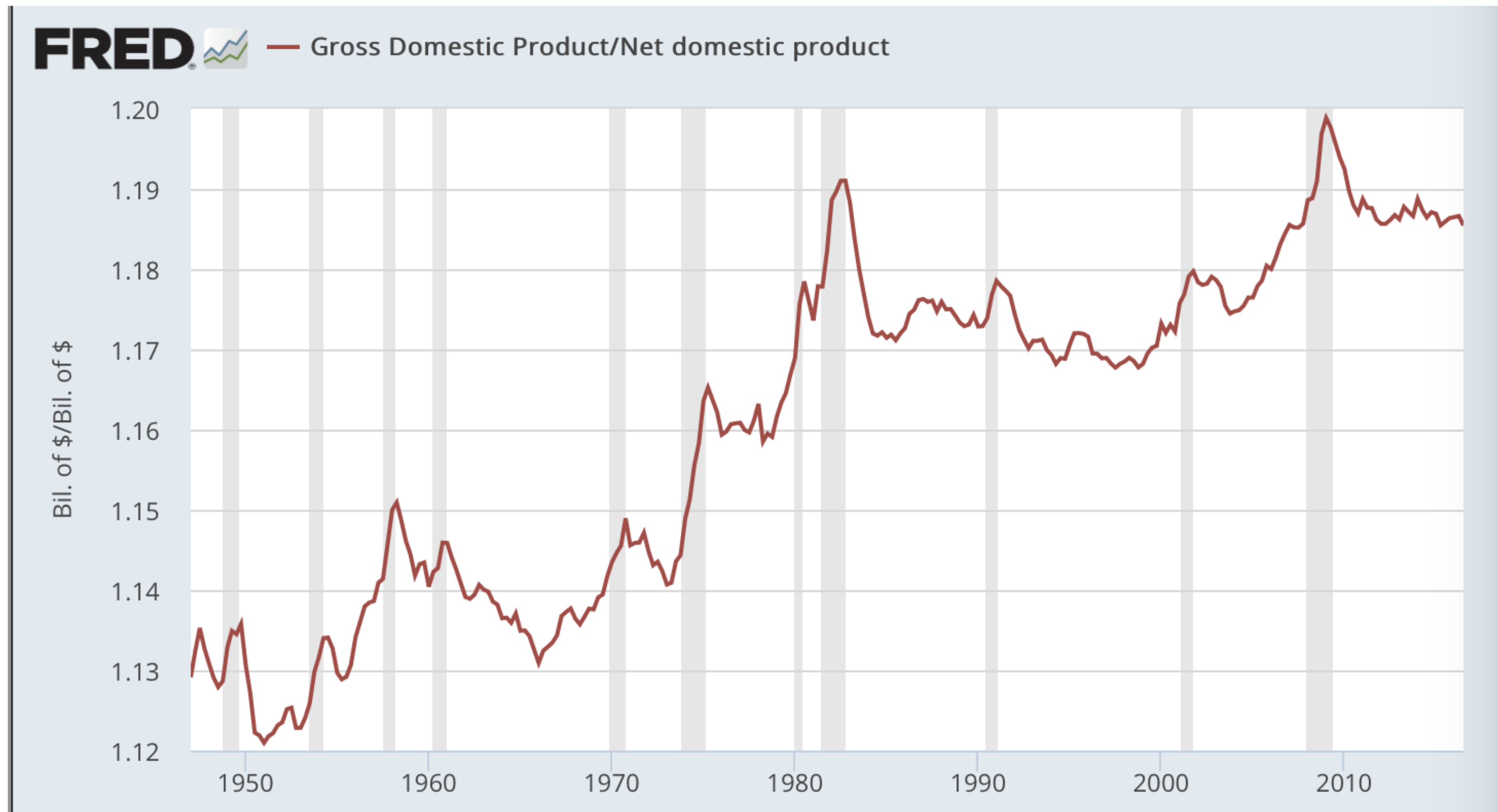
Empirics

- This was intriguing.



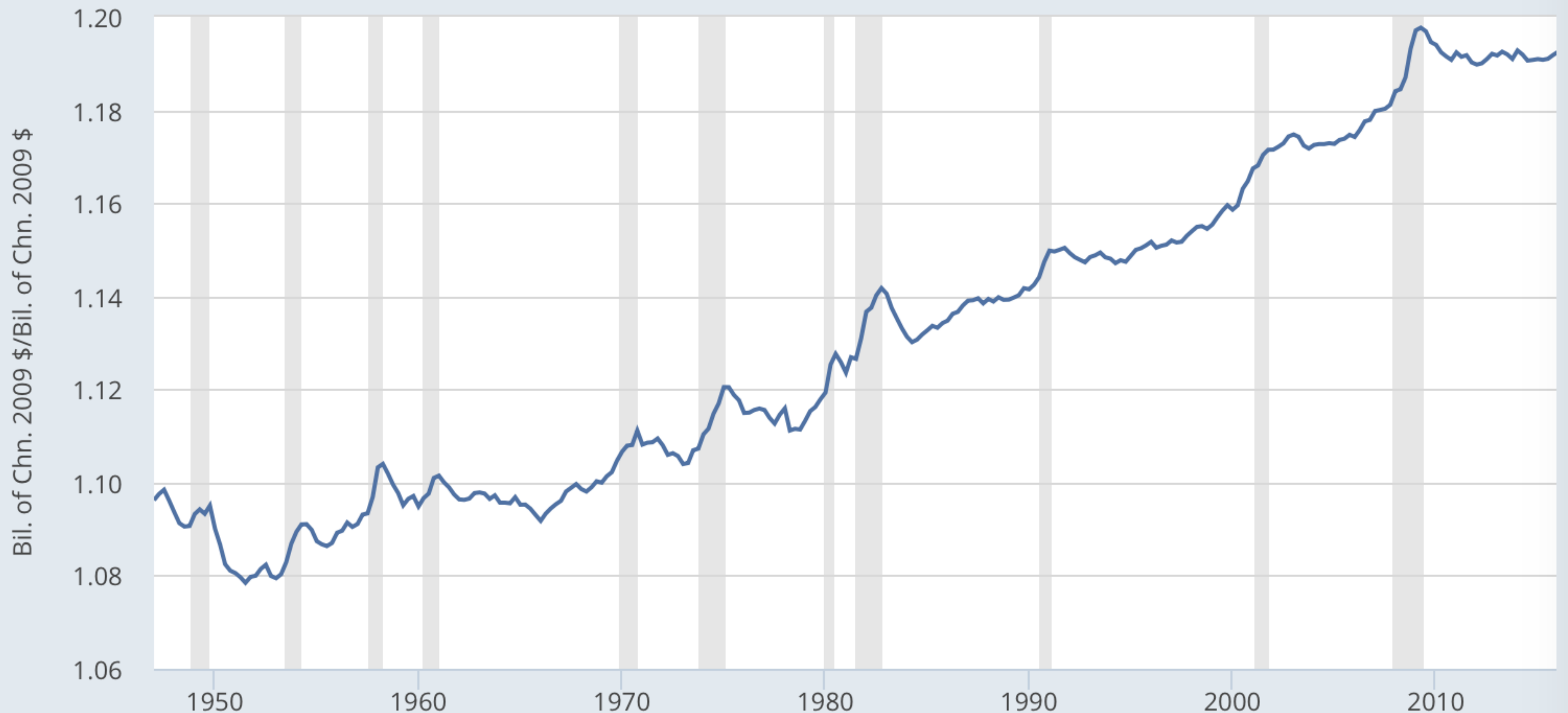
Empirics

- But then I got confused.



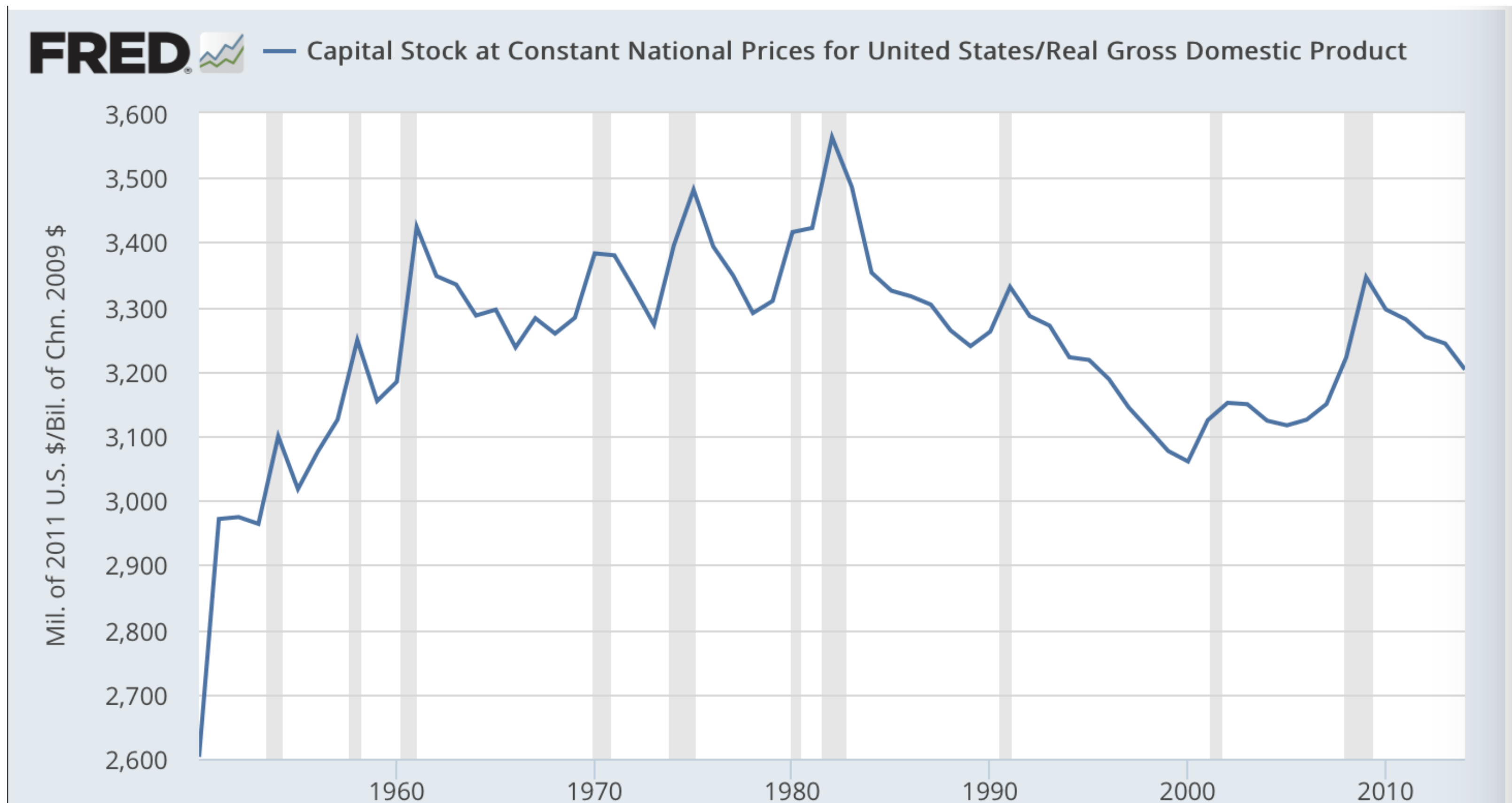
Empirics

- In real terms the ratio is easier to read although less supportive for the story of the paper.



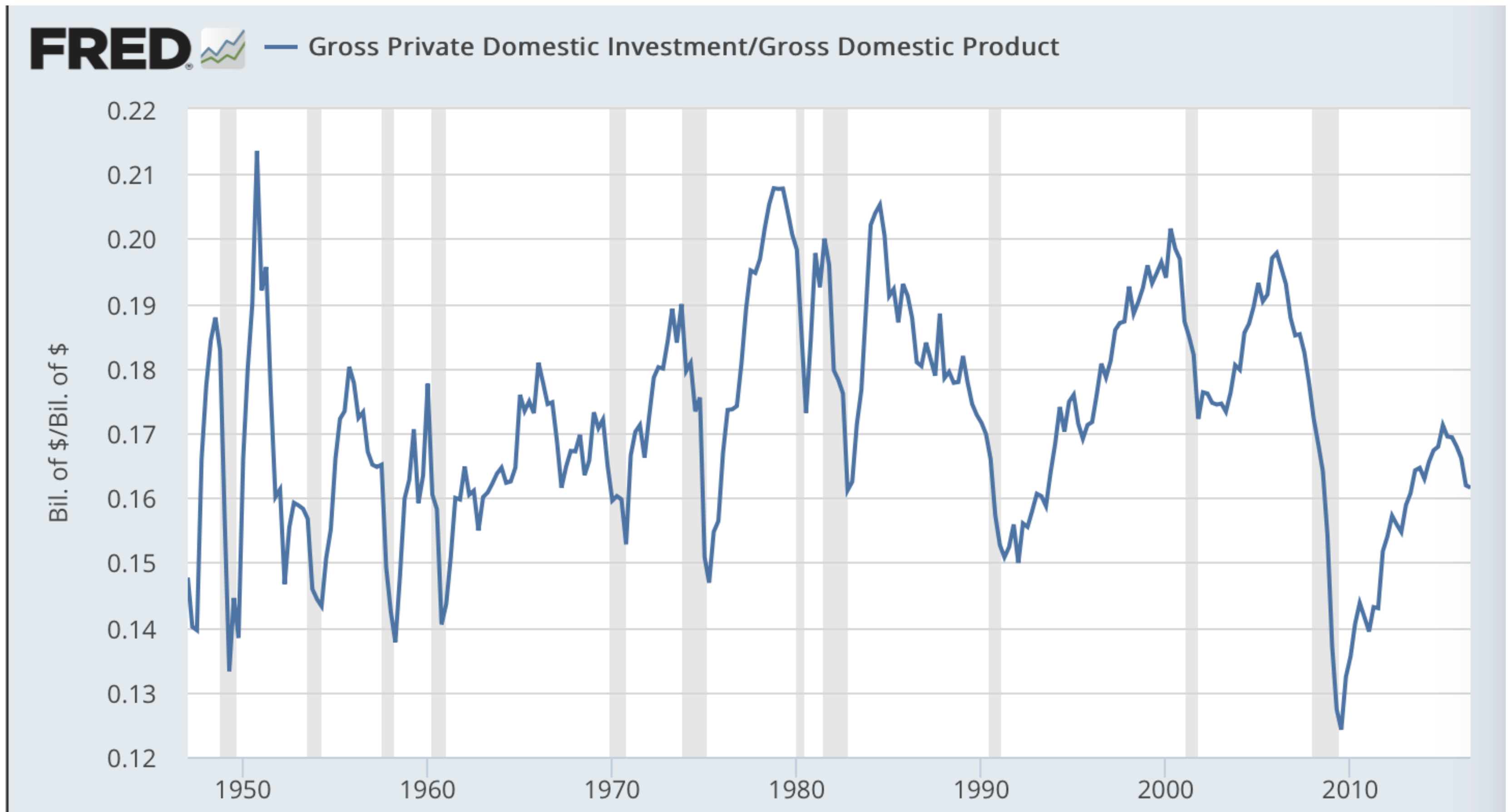
Empirics

- Is it about the Capital Stock?



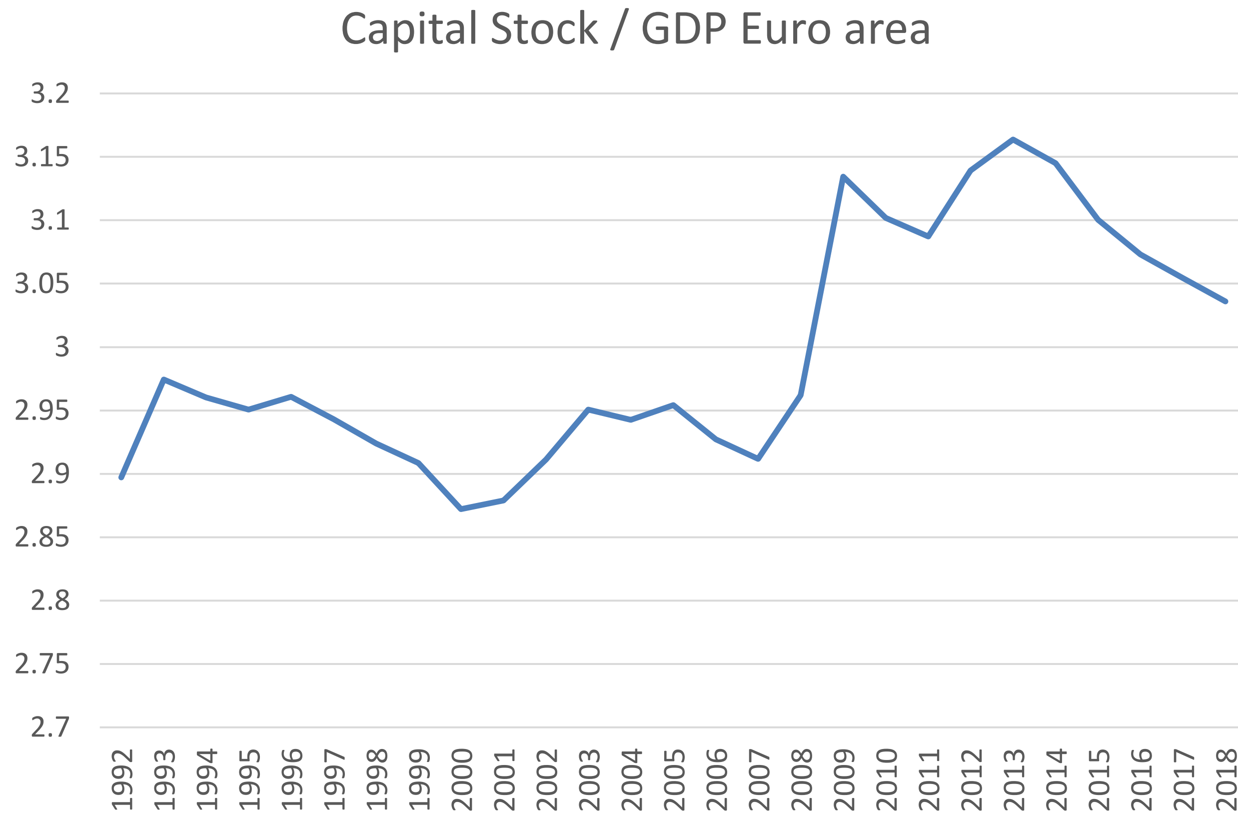
Empirics

- Check Investment



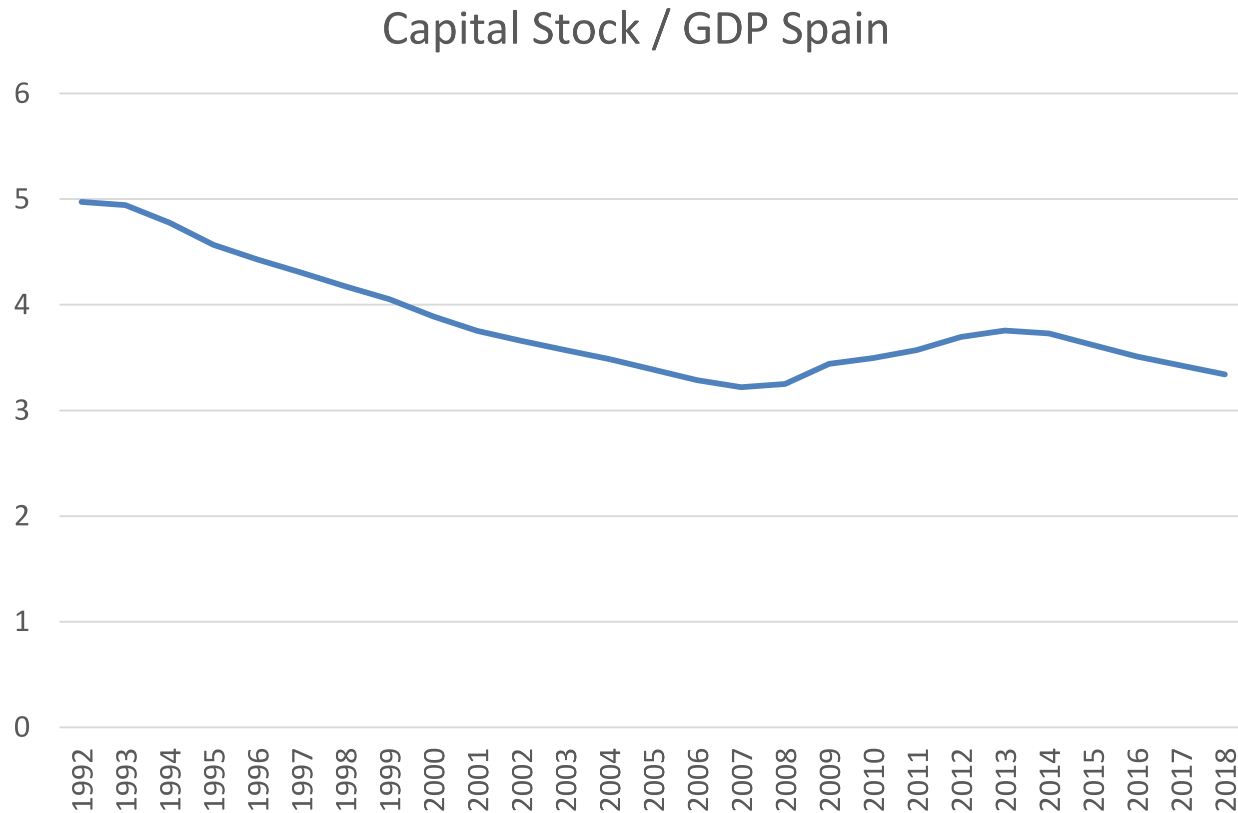
Empirics

- Do we see any of this in Euro area? No



Empirics

- Do we see any of this in Spain? No



Empirics

- Other supporting evidence:
  - Asset Prices
  - Lending standards, book profits
  - Real Wages
- But (again) these are predictions of many other models as well

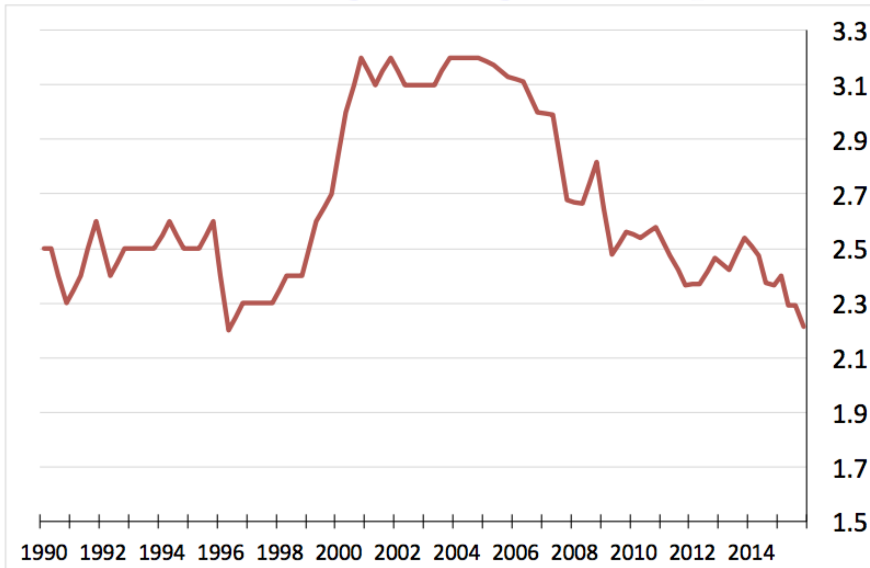
- Better test would be to compare different recessions assuming that financial system involvement differs across recessions because of changes in regulation

- Quantifying the magnitude of the distortion. Need to assume economy goes back to pre-late 1990s "no distortion state"; use capital stock to infer key parameter (but any story that affects capital stock, consistent with calibration); real cost of capital, depreciation not quite matching the model,…

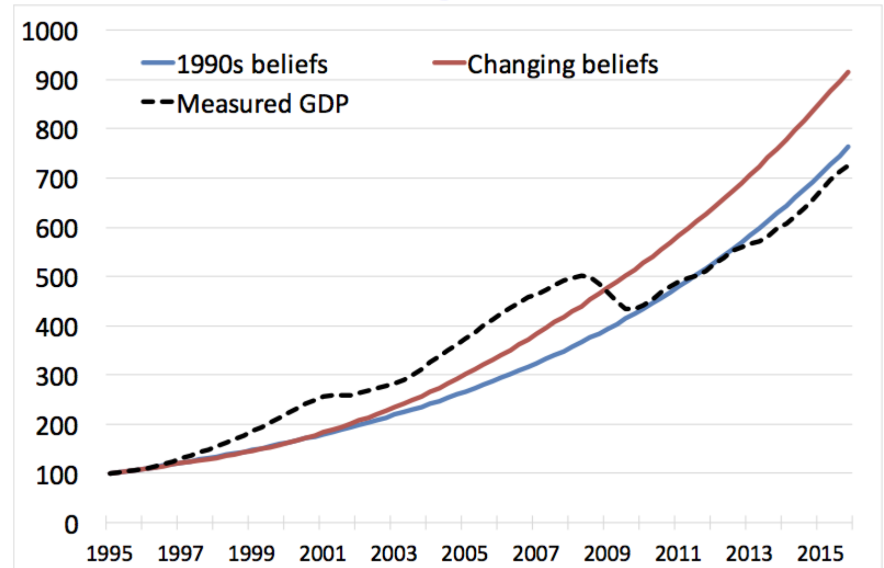
Empirics

- Growth delusion effects.

A. Consensus Long-Term growth expectations



B. What if trend GDP growth didn't increase?



- This runs contrary to conventional wisdom on productivity